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Political Patronage on Capital Structure in Indonesia

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ABSTRACT

Objective – The purpose of this research is to test the theory of capital structure by determining whether the relationship is affected by Political Patronage. The study will examine political support, capital structure and financial performance of the company.
Methodology/Technique – The data in this research is in the form of financial ratios displayed in the financial report of each company listed from 2010 to 2016. The sample was selected using purposive sampling with as many as 70 companies indicated to have political support. The data was analysed using regression analysis.
Findings – The results show that Political Patronage has an influence on capital structure and political Patronage has a weak effect on financial performance.

Type of Paper: Empirical

Keywords: Political Patronage; Capital Structure; Financial Performance.

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JEL Classification: G30, G32, G39.

1. Introduction

The development of capital structure theory begins with the relevant theory of capital structure associated with firm value and the second view that capital structure is irrelevant to firm value. Several recent studies have linked capital structure with political patronage.

This study aims to examine various views related to political patronage and capital structure, using different proxies to measure political support.

Empirical findings show that there is a direct relationship between the political patronage of the government and the party supporting the government towards capital structure (Kamaludin, 2010). Duan and Chik (2012) and Li, Meng, Wang and Zhou (2008) suggest that there is an indirect relationship between political patronage and capital structure through firm size and profitability.

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Habib, Muhammadi and Jiang (2017) state that companies that have political patronage and a transactor link with certain parties and obtain loans from banks will increase the value of the company. Nys, Tarazi and Trinugroho (2015) believe that politically-motivated banks will get a stronger and faster supply of funds from the government in terms of withdrawal of deposits. Fu, Shimamoto and Todo (2017) explain that political connections in terms of access to finance are more prominent in MSMEs than larger, publicly traded companies. This is because political connections are more personal between company owners and politicians. A formal connection can be seen from the ownership of shares or institutional or political involved in the composition of the board of directors.

Several other studies have also identified a link between the era of political support and the ease of financing. Fu et. al. (2017) states that firms with strong political relationships in Indonesia receive preferential treatment from banks in two ways. First, as companies are more likely to borrow from state-owned banks, they are more likely to receive full loans in accordance with the amounts they ask. Second, political patronage for the company can also affect the performance of the company due to the impact of excessive use of debt (Kamaludin, 2010). The following research questions are raised: 1) Does political patronage affect a company's performance? and 2) Does political patronage affect capital structure?

2. Literature Review

2.1 Capital Structure and Political Patronage

Gomez and Jomo (1999) and Johnson and Mitton (2003) describe relationships with politics, as falling within 1 of the following categories: 1) the company owns or is the largest shareholder with someone who has a relationship with the president, minister, or a parliamentarian; 2) connections with officials who have been presidents or ministers in the past; 3) companies with top executives or former countries in politics; 4) connections with foreign politicians; and 5). others in previous studies. The relationship between business and politics has resulted in politically connected companies. A so-called politically-connected company is one in which the largest shareholders (or indirectly and indirectly controlling 10% of the vote) or a member of the board of directors (CEO) is a parliamentarian, or a head of state, or a person who has a close relationships influential politicians (Faccio & Lang, 2002).

Company political patronage can be viewed from various characteristics as established by Johnson and Mitton (2003). Fraser, Zhang and Derashid (2006) and Faccio (2010) show that political patronage has a very important role in determining the level of corporate leverage. Political patrons can also affect the costs companies incur when financing, such as the cost of debt (Bliss & Gul, 2012) and the cost of equity (Boubakri, Guedhami, Mishra, & Saffar, 2012). Companies that have a close relationship with government or political institutions benefit from the existence of such political relationships. Faccio, Masulis and McConnell (2006) explain that economically depressed and politically connected companies are more likely to be bailed out by governments than other companies. However, Sujoko and Soebiantoro (2007) explain that the increasing amount of debt experienced by those companies can cause financial distress and ultimately impairment.

The creation of the relationship between politics and a company arises from their own interests and advantages. The government benefit from the companies help with the formulation of public policy including in the interests of business, as well as corporate activities to achieve the government’s political goals. For the company, this relationship is useful in terms of tax breaks, winning government projects, receiving monopoly facilities and other conveniences that help the company's business activities. Mobarak and Purbasari (2006) show that in Indonesia, companies associated with President Soeharto at that time systematically benefited from import licenses. Khwaja and Mian (2005) show that former politicians provide government bank loans to companies that are politically engaged in Pakistan. Faccio (2006) adds that the government has a tendency to provide bailouts to companies that have political backing in times of financial distress. Furthermore, politically-motivated companies, in general, can pay lower taxes and earn lower operating costs (Faccio, 2010).

In Indonesia, the practice of collusion between rulers and entrepreneurs is a very fertile practice particularly in the final years of the reign of Soeharto's presidential regime. Many policies that are justified in the national interest turn out to benefit only certain groups (Deliarnov, 2006). Rachbini (2001) explains that concrete evidence of political support is characterized by two features, namely, the growth of highly leveraged firms working on a large scale and on a national scale.

Several other studies related to capital structure (Kamaludin & Usman, 2017) in SOEs have a different capital structure for firms classified as healthy, unwell and not healthy. In addition, there is a linear relationship between debt to assets (DA), current ratio (CR), asset utility (AU), and ROA. This means that healthy companies tend to have low DA and otherwise. Habib et. al. (2017) states that companies that have political support and relationships with certain parties and obtain loans from banks will increase the value of the company. Companies with political connections are companies or conglomerates with close relationships with the government or politicians. The firms with political connections are more likely to take risks and are therefore more likely to fail (Wahab, Zain, & James, 2011; Johnson & Milton, 2003). Gul (2006) states that a company with political support has a greater probability of a mop error reporting and overstatements in their income to avoid debt by the bond. Based on the above, the following hypothesis is proposed:

H1: Political support has an effect on capital structure.

2.2 Company Performance and Political Patronage

Various studies have identified a correlation between political patronage and firm performance. Bouresli (2001) and Lin (2007) explain that the debt ratio has a negative effect on firm performance, while Calisir, Altin, Elvan and Deniz (2010) describes this as a positive effect. Xu, Zhu and Lin (2005) explain that in China, when political control is limited, corporate performance improves. This occurs when there are increased outcomes in corporate flexibility in terms of employment and the enforcement of more effective corporate governance mechanisms.

Dao (2013) states that banks in Vietnam which are connected to politics perform better than those with no political links. Politically connected companies are found to enjoy some advantages such as easy access to bank loan financing, tax breaks, market forces, and receiving government contracts (Wijantini, 2007). This is in line with Husnan's (2001) opinion that some politically connected companies can easily obtain debt financing by obtaining a "memo loan" from politicians. Several other studies have shown that firms with politically connected CEOs have a significant effect on firm performance after an IPO (Chen, Fan, & Wong, 2004). The decline in stock performance after the IPO shows that companies with politically connected CEOs perform better than those with politically unrelated CEOs (11% one year after IPO, 15% to 16% two years after IPO and 35% to 37% three years after IPO).

Politically connected companies spend a lot of money to get the convenience so that it can reduce the end result of the profits obtained. The results of this study support the findings of Fan, Wong and Zhang (2007) who state that in China, a company with a CEO connected with politics has a lower performance compared with those companies that are not connected politically as seen from the stock returns after the IPO within three years. Chantrataragul (2007) also found that politically connected firms have lower performance than non-political companies when viewed from the ratio of ROA. Faccio (2006) suggests that politically-affiliated companies have lower performance than firms with no political affiliation on the basis of accounting. This is possible because when politicians channel resources to the targeted company, this can create distortions of incentives, and mis-allocation of investments and increase corruption (Shleifer & Vishny, 1994). Leuz and Oberholzer (2003) provide evidence that in Indonesia, companies are facing difficulties in building relationships with new governments when their patronage fall out of power, causing these companies to perform poorly and consequently turn to overseas finance. Keep in mind that the ease of getting a loan increases a company's debt so that the company increases its' burden. Kamaludin's (2010) findings are also consistent with previous research that politically motivated companies tend to have high leverage and low utility assets which ultimately degrade the company's performance. From the above description, the following hypothesis is proposed:

H2: Political support affects company performance.

3. Methodology

3.1 Measurement of Variables

The following will be done to each variable used in the research and the indicators in the study shown in Table 1. The data in the form of political support collected in this study is generally in the form of rank data showing the level of each and the ratio. The data in the form of political support is converted to interval data.

Table 1. Measurement of Variables

Number	Variable	Proxy	Scale	Value	Source
1	**Political Patronage:**				
	Share ownership by politicians within the company: (PP1)	Share ownership 20%	Interval	1	Faccio(2006); Jhonson & Mitton (2003); Fraser, et al (2006)
		Share ownership 40%	Interval	2	
		Share ownership 60%	Interval	3	
		Share ownership 80%	Interval	4	
		Share ownership 100%	Interval	5	
	Political involvement/ government officials within the company: (PP2)	President / Vice President / DPR RI1)	Interval	5	
		Governor / Vice Governor / DPRDI2)	Interval	4	
		Regent/Vice Regent/ /DPRDII3)	Interval	3	
		Officials TNI4) /POLRI5)	Interval	2	
		Leaders of Political Parties	Interval	1	
	Political involvement in management or other in the company: (PP3)	President Commissioner / President Commissioner	Interval	5	
		President Director	Interval	4	
		Commissioner	Interval	3	
		Director	Interval	2	
		Others	Interval	1	
2	Capital Structure:				Sugihen (2003); Bouresli (2001); Calisir, et al (2010)
	Debt to Asset (DA)	Total Debt: Total asset	Ratio	%	
	Debt to Asset (DE)	Total Debt: Total equity	Ratio	%	
3	Performance Company:				Fan, et al (2007); Chantrataragul, (2007); Kamaludin & Pribadi (2011); Wong (2010).
	Return on Asset (ROA)	EBIT: Total Asset	Ratio	%	
	Return on Equity (ROE)	Net Income/Equity Income	Ratio	%	

Note:

1) National Council of the Republic of Indonesia (DPR RI)
2) Provincial Council of the Republic of Indonesia (DPRD-I)
3) District Council of the Republic of Indonesia (DPRD-II)
4) Army of the Republic of Indonesia
5) Police of the Republic of Indonesia

3.2 Population and Sample

The population in this study is companies listed on the Indonesia Stock Exchange from 2010 to 2016. Public companies are selected because those companies are required to submit financial reports and annual reports to the public so as to facilitate the researchers in the collection of data.

The research sample is determined by first identifying the political relationship to the composition of the board of commissioners and the board of directors of the company. Identification is done by matching the composition of the board of commissioners and the board of directors with the composition of the government cabinet and the composition of members of the People's Legislative Assembly of the Republic of Indonesia, using information obtained from the mass media about the political interests and the closeness / kinship of a company to the economic policy set by the government. The research data is obtained from secondary data of the companies listed on the Indonesian Stock Exchange (IDX) i.e. financial reports (annual report) for the period between 2010 and 2016. The sample is presented in Table 2.

Table 2. Company Data which made the Object of Research by Business Sector

Number	**Business Sector**	Total	**Number**	**Business Sector**	Total
1	Agriculture, Forestry and Fisheries	3	12	Metal products	1
2	Animal food	1	13	Mining	10
3	Textiles	2	14	Paper	1
4	Automotive	3	15	Pharmacy	3
5	Banking	2	16	Plastic and glassware	3
6	Chemistry	1	17	Real Estate and property	12
7	Construction	2	18	Securities	1
8	Food and Drink	2	19	Telecommunication	3
9	Investation	3	20	Trade and wholesale	5
10	Insurance	1	21	Transportation	3
11	Wood	2	22	Others	6
	Total	22		Total	48
Total General: 70					

Source: Research Data, 2017.

4. Results and Discussion

4.1 The Influence of Political Support to Capital Structure

This study examines theories of company financials related to capital structure theory and company performance theory. Political Patronage (PP1 and PP3) has an effect on capital structure (DA), and Political Patronage (PP2) has a significant influence on capital structure only (DE). Political Patronage (PP2) has no effect on capital structure (DA).

Political support (PP1 and PP3) has no effect on capital structure (DE), which is the overall result shown in Table 3. The results of this study are in line with Friedman (1999) who states that political support influences capital structure. The results also demonstrate that bankers are forced to lend to projects undertaken by politically affiliated companies although the project is not expected to be profitable.

Table 3. Political Patronage and Capital Structure

Model	Beta	T	Sig	R	R Square	F
PP1 ... DA	0,118	2,184	0,030**)	0,115	0,013	4,770
PP2 ... DA	0,039	0,710	0,478	0,038	0,001	0,505
PP3 ... DA	0,070	2,140	0,033**)	0,112	0,013	4,581
PP1 ... DE	-0,109	-0,400	0,689	0,021	0,000	0,160
PP2 ... DE	0,596	2,205	0,028**)	0,116	0,013	4,863
PP3 ... DE	0,270	1,271	0,205	0,067	0,004	1,614

Note: *) 1%, **) 5%, ***) 10%

Political patronage (PP1 and PP3) has an effect on capital structure (DA) but political patronage (PP2) has no effect on capital structure (DA). This is because the involvement of politicians as high officials of the state does not appear much in the corporate management structure - if they are involved in the company they do not have an active role. Several factors may affect capital structure, such as the nature of company management, business risk, economic conditions, and several other factors (Kamaludin & Indriani, 2012).

Political patronage (PP1 and PP3) has no effect on capital structure (DE), but political patronage (PP2) has a significant effect on capital structure (DE). The results of this study show that the ownership structure can affect the performance of companies which will necessarily have an impact on the risk of bankruptcy to a company. These findings are consistent with the findings of Wahab (2011) who states that politically-linked companies will use their influence to gain easier access to soft loans.

Looking at some proxies is not all significant between political patronage (PP2) to capital structure proxy (DA), and between political patronage (PP2 and PP3) and capital structure (DE). This is because political support is not the only factor that determines the capital structure. Capital structure is determined by many things such as firm size, financial risk, management attitude, and others. The results of this study show that theories of conventional capital structure cannot always be proved, meaning that this study reinforces that the theory of capital structure based on the relationship as proposed by Jonson and Milton (2003), Frazzer et. al. (2006), and Kamaludin (2011).

4.2 The Influence of Political Patronage on Company Performance

The results show that Political patronage (PP1) had an effect on company performance (ROA and ROE) but with a 10% confidence level. Political patronage (PP2 and PP3) has no effect on company performance for both ROA and ROE (see Table 4). The weak interrelationship of political patronage to the company's performance may be because the companies with political support have a more aggressive debt structure which certainly has a high-interest expense so as to degrade the performance of both ROA and ROE. The results of this study are consistent with research conducted by Wahab et. al. (2011) on several companies in Malaysia, that there is no significant influence between government relations and company performance. Further, political patronage (PP3) does not have a significant effect on ROA and ROE. Osamwonyi and Tafamel (2013) state that there is no significant relationship between the composition of the board, the composition of political connections, and company performance.

Some other authors obtain different results. For example, Winanda and Ardiyanto (2009) and Nuraeni and Chairiri (2010) state that share ownership structure also affects the company's performance. Fan et. al. (2007) explains that firms with affiliated political CEOs have lower performance than firms with no political affiliation. Jhonson et. al. (2006), Khwaja and Mian (2005) and Sapienza (2002) state that the transfer of wealth to politically affiliated companies will lead to an increase in corporate value. Likewise, Wong (2010) states that companies that have political connections have better financial performance compared with those who have no political connections.

Table 4. Political Patronage and Performance

Model	Beta	T	Sig	R	R Square	F
PP1 ... ROA	-0,734	-1,688	0,092***)	0,089	0,008	2,850
PP2 ... ROA	-0,270	-0,618	0,537	0,033	0,001	0,382
PP3 ... ROA	-0,272	-1,037	0,301	0,055	0,003	1,075
PP1 ... ROE	-2,834	-1,696	0,091***)	0,089	0,008	2,877
PP2 ... ROE	1,320	0,786	0,432	0,042	0,002	0,618
PP3 ... ROE	1,441	1,431	0,153	0,075	0,006	2,048

Note: *) 1%, **) 5%, ***) 10%

In contrast to the above, Chantrataragul (2007) states that political connections have a significant positive influence on corporate performance. Further, Wong (2010: 275) states that political connections have an effect on the company's performance and Wijantini (2007) believes that politically connected companies are found to enjoy benefits such as easy access to bank loan financing, tax breaks, market power, and receiving government contracts.

5. Conclusion

Political patronage 1 from the aspect of share ownership and political patronage 3 from the involvement of political elements and authority in company management affect capital structure and debt to asset ratio (DA), but do not affect the capital structure of debt to equity (DT). Political patronage 2 from the top aspects of company management with a connection to power or politics affects the debt to equity ratio (DE), but does not affect the debt to assets ratio (DA). Political patronage (PP1), political patronage (PP2), and political patronage (PP3) have a negative effect on company performance from the aspect of Return on Assets (RoA). Whereas (PP1) has a negative effect on Return on Equity (RoE), and PP2 and PP3 have a positive effect on company performance.

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